

The background of the slide features a warm, golden-toned image. It shows several stacks of coins, including a 1 Euro coin and a 10 Euro coin, resting on a surface. Overlaid on the coins is a financial candlestick chart with red and blue bars, and a green line graph, suggesting a focus on finance and accounting.

# Deloitte.

Aligning accounting for  
hedges with risk  
management objectives of  
the enterprise

Adoption of IND-AS 109

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2015

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# Foreword

The pervasive nature of financial risk has led to increased sophistication in the risk management programs of organizations. Underlying business contracts and pricing structures have increased complications in ascertaining the nature of risk and off-setting the risk through the use of derivatives. While risks being hedged are expected to materialize in the future, derivative transactions to offset them are required to be taken today. Further, derivatives are expected to be marked to market on each reporting date, with the resultant impact of such mark to market being recorded in the financial statements immediately. This creates a financial reporting imbalance wherein the impact of derivatives is recognized in a different period from the impact of underlying financial risks.








To mitigate this financial reporting imbalance, a number of organizations chose to adopt the hedge accounting principles of AS-30. This enabled the recognition of gains/ losses from cash flow hedges in the statement of profit and loss in the same period as the gain/ loss resulting from the underlying financial risk. While this alleviated some of the mismatch in financial reporting, it still did not facilitate proper understanding of the off-set by readers of financial statements. This happened primarily on account of AS-30 being more rule-based

than-principle based. Wherever an organization's risk management strategy did not fit the rules defined by AS-30, the essence of the risk management objective was not always reflected appropriately in the financial statements.

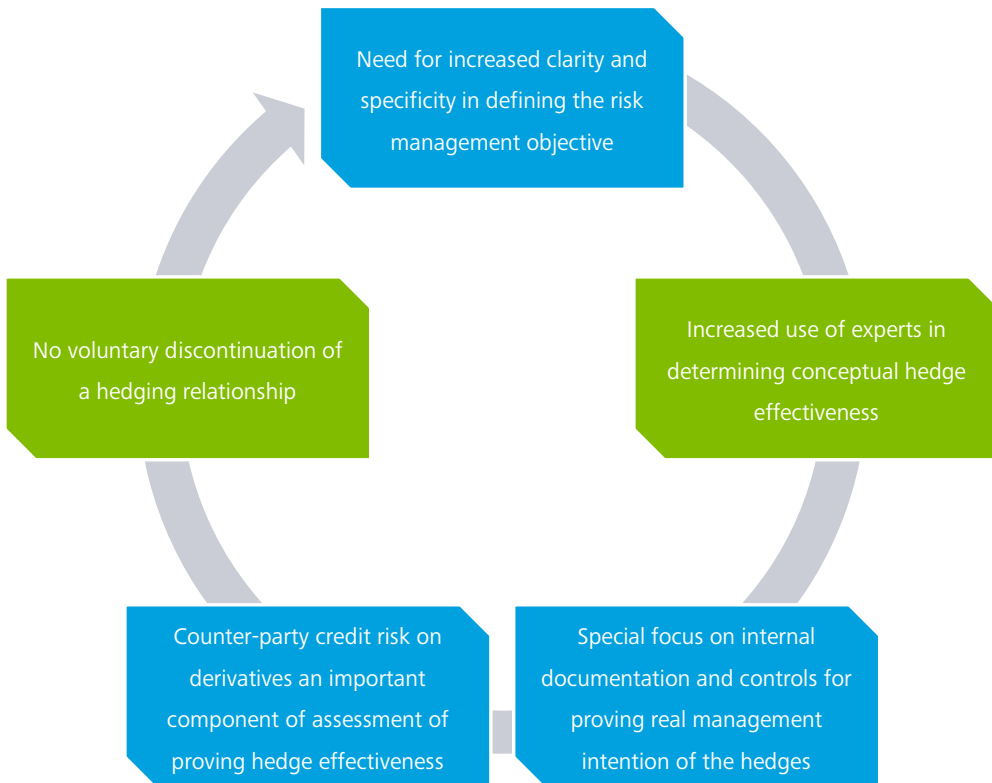
With the advent of IND-AS and the possibility of adopting IND-AS 109, a number of challenges posed by AS-30 can potentially be addressed. Implementing IND-AS 109 in the right manner can also help organizations appropriately reflect the offset from hedges and underlying exposures both in the statement of profit and loss and for the purpose of internal reporting. Accordingly, once implemented correctly, IND-AS 109 should remove the disparity in internal representation of the risk management objectives and reporting in financial statements.

While IND-AS 109 allows for greater alignment between the risk management objectives and hedge accounting, it also requires increased clarity in defining the risk management objective of the enterprise. The role of experts in understanding pay-offs from hedging instruments and whether they adequately off-set the underlying financial risk also takes precedent.

## Challenges that can potentially be addressed by adoption of IND-AS 109:

	Proving hedge effectiveness for commodity related hedges where only the benchmark component of the pricing is being hedged.
	Volatility in P/L caused on account of change in time value of options even where such options are part of a hedging relationship
	Inability to designate only part of the notional of a derivate as part of the hedging relationship
	Time and effort involved in proving statistical hedge effectiveness even in case of simple hedging transactions
	Potential for hedges being ineffective due to statistical hedge effectiveness testing methods even where real cash flows from hedges and underlying exposures off-set each other
	De-designation and re-designation issues arising from re-balancing the hedge portfolio
	Inability to aggregate an exposure with a derivative instrument for the purpose of hedging a combination of financial risks as part of single hedging relationship

**Aspects to consider while adopting IND-AS 109**



This document discusses how IND-AS 109 can address some of the challenges posed by the hedge accounting principles under AS-30. It also explains the aspects that organizations need to consider before adopting IND-AS 109.

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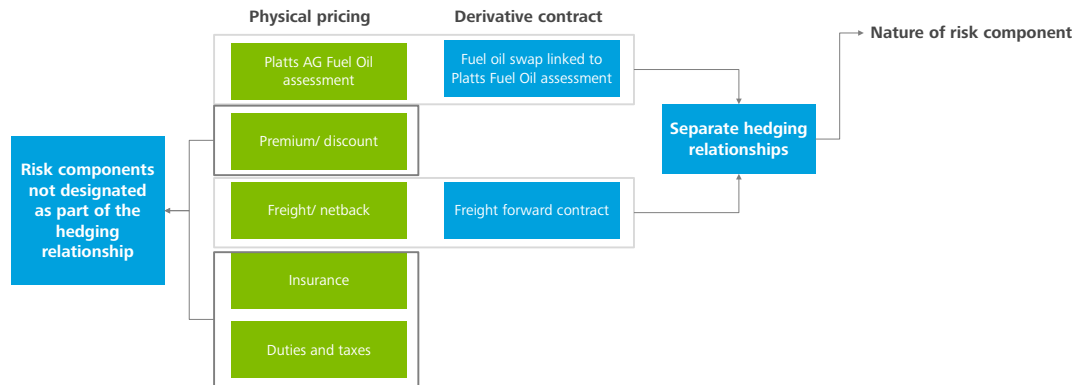


# Hedging specific risk components

Hedge accounting under AS-30 required a specific risk to be hedged in its entirety, which poses challenges especially in case of hedging commodity price risk. Typically, in the case of commodity pricing, the final price for physical transactions are arrived at after adjusting a quoted or polled benchmark price for other components such as freight and quality premiums/ discounts. However, derivative contracts that are undertaken to off-set the physical price risk cover only the pricing benchmark. In reality, the other components included in the physical pricing may not move in tandem with the pricing benchmark.

Under AS-30, statistical hedge effectiveness testing is required and risk is required to be designated in its entirety. This means that an entity is comparing the change in the fair value of the derivative (which is essentially the pricing benchmark alone) with the change in the fair value of the physical commodity (which covers the benchmark and multiple other components). Accordingly, even where the benchmark component of the pricing for both the derivative and the hedge perfectly off-set each other, the hedge could still be ineffective under AS-30.

IND-AS 109 permits a hedging relationship between a derivative and a specific risk component of a non-financial hedged item. Accordingly, an organization can choose to only designate the pricing benchmark (for example LME quote for copper or Platts assessment for fuel oil) as part of the hedging relationship. This mitigates the potential for ineffectiveness of the hedge. IND-AS 109 however requires that for hedging only a specific risk component, the risk component should be separately identifiable and reliably measurable



Adopting IND-AS 109 would facilitate application of hedge accounting for a number of commodity hedges that would earlier fail the hedge effectiveness test

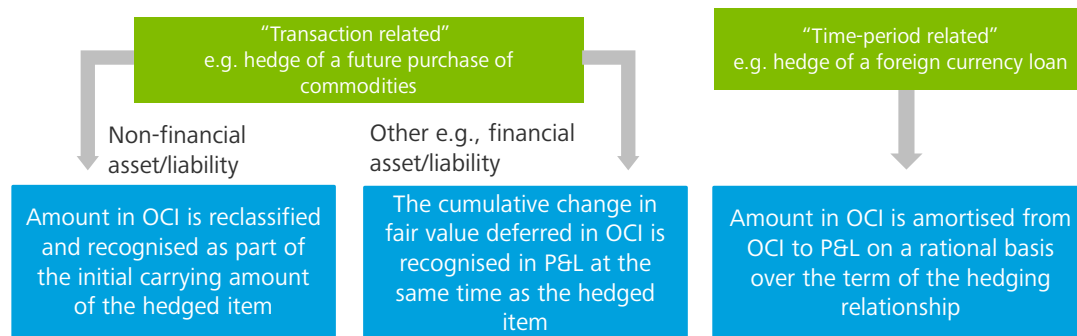
# Managing P/L volatility caused by time value component

AS-30 permitted splitting the time value component for both forwards and options. However, once time value was split and the intrinsic value was designated as part of the hedging relationship, AS-30 required that changes in time value at each reporting date be recognized in the statement of profit and loss. Since time value changes between reporting dates could not be amortized evenly, this created P/L volatility.

IND-AS 109 recognizes that time value component relates to the cost of hedging. Accordingly, where the critical features of an option are aligned with the underlying exposure (i.e., hedged item), the time value can either be amortized or carried in the other comprehensive income (OCI) depending on whether the hedge is transaction related or time related.

IND-AS 109 recognizes that time value pertains to cost of hedging and this should not lend volatility to the statement of profit and loss.

IND-AS 109 requires that the organization determine whether the time value relates to a transaction related hedged item or to a time-period related hedged item. Depending on what the time value is related to, the organization can undertake the following accounting treatment:



IND-AS 109 recognizes that time value pertains to cost of hedging and this should not lend volatility to the statement of profit and loss.



It is important to keep in mind that to enable the aforesaid treatment of time value, the critical features of the hedging instrument should be aligned with the hedges item. If that is not the case, then expert assessment would be required to determine what portion of time value aligns with the critical features of the underlying hedged item.

# Partial designation of a hedging instrument

AS-30 requires that a hedging instrument should be designated in its entirety. It does, however, permit a hedging instrument to be designated as part of multiple hedging relationships. What this means is that when an organization takes a hedge for say USD 1 million, it cannot designate USD 0.5 million and leave the balance USD 0.5 million undesignated. This situation gets complicated further where a part of the underlying is no longer highly probable and an entity has taken a single hedge that is equal to the entire notional of the originally forecasted transaction. AS-30 requirement that the entire hedge be treated as part of a hedging relationship means that even if a small portion of the underlying becomes unlikely to materialize during the course of the hedging relationship, the entire hedging instrument becomes undesignated.

IND-AS 109 allows for a proportion of the entire hedging instrument, such as 50 per cent of the notional amount, to be designated in a hedging relationship. This takes the emphasis away from the notional amount in specific term sheets and enables corporate treasurers to decide the notional amount without focusing on accounting considerations.

**IND-AS 109 does not however allow for designation of the following nature:**



- Designating a hedging instrument for part of its life is not permitted
- A written option cannot be designated as part of a hedging relationship unless it is designated as an offset to purchased options



# Limited emphasis on statistical hedge effectiveness testing

AS-30 requires that statistical hedge effectiveness testing be undertaken even in case of simple hedging instruments such as forwards. AS-30 also requires that the hedge effectiveness testing be undertaken at inception and at each reporting date. While statistical hedge effectiveness testing provided a good measure of effectiveness, there were certain challenges associated with it:


- While using the dollar off-set method even in case of simple forwards, small changes in fair value could cause ineffectiveness.
- Statistical hedge effectiveness testing for non-linear instruments required more complicated methods, such as regression testing, which were time consuming.
- Even in case of fully hedged transactions where off-sets were 100%, there was a need to continuously prove hedge effectiveness testing. This tended to be a theoretical and tedious exercise at each reporting period.

IND-AS 109 defines hedge effectiveness as the extent to which changes in fair value or cash flows of the hedging instrument off-set changes in the fair value or cash flows of the hedged item. **This is more consistent with business realities and the real intent of undertaking hedging transactions.**

IND-AS 109 also lays down simpler criteria for passing the hedge effectiveness test. These involve examining the economic relationship between the hedged item and the hedging instrument, ensuring that the effect of credit risk does not dominate fair value changes and that the hedge ratio is consistent with the defined risk management objective. **Most importantly IND-AS 109 allows for undertaking qualitative assessments of hedge effectiveness in place of statistical hedge effectiveness testing required by AS-30.** While IND-AS 109 simplifies the hedge effectiveness testing requirements, it is important that an organization exercises appropriate expertise relating to the following aspects:



While IND-AS 109 does away with the 80:125 bright line, it does still require that off-set be evaluated. Based on the off-set between the hedge and underlying exposure, the amounts to be carried in the reserve and taken to P/L will be determined.



# Uncomplicated documentation and accounting for portfolio hedging

Re-balancing the hedge portfolio by making changes in the quantum of hedged item and hedging instrument tended to be complicated under AS-30. While portfolio hedging was recognized to a certain extent, most rebalancing decisions were likely to lead to de-designation and re-designation of hedging instruments. This created voluminous documentation and a need to track amounts carried in the hedge fluctuation reserve even after hedging relationships were terminated.

IND-AS 109 makes portfolio re-balancing a lot smoother. Where the quantum of either the hedged item or hedging instrument has changed, the hedging relationship can continue by simply adjusting the hedge ratio. This is typically more reflective of an entity's hedging strategy especially where organizations are hedging a portfolio of receivables or are seeking to hedge the duration of an interest rate portfolio.

IND-AS 109 does, however, require that while re-balancing the hedge portfolio the risk management objective does not change. Where the risk management objective changes, the hedging relationship will require to be discontinued. **Given the emphasis the standard places on the risk management objective, it is important to ensure that the hedge documentation clarifies the risk management objective from the inception of the hedging relationship.**

While portfolio re-balancing is permitted, discontinuing a hedge relationship voluntarily is not permitted under IND-AS 109.

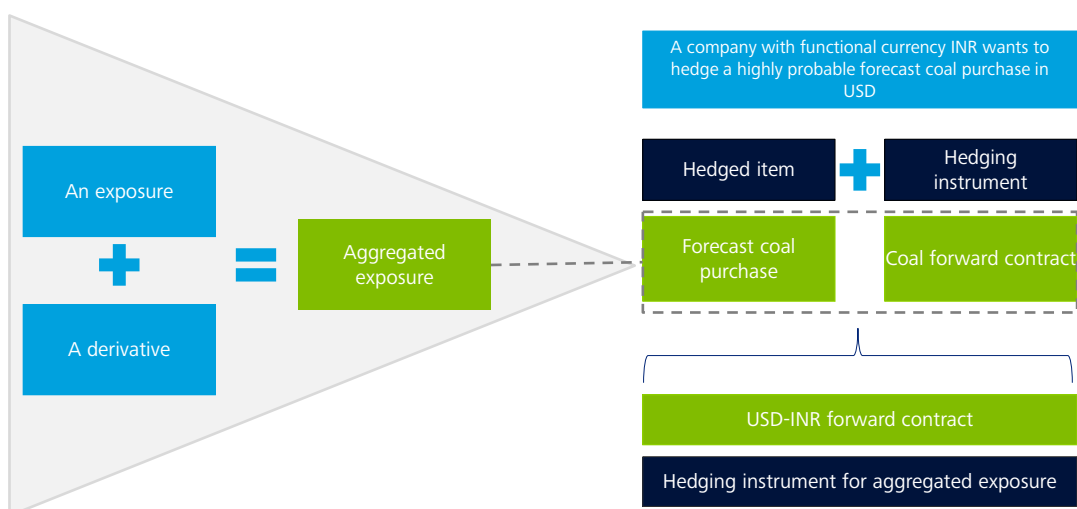


- Voluntary de-designation of hedging relationships is not permitted under IND-AS 109.

# Aggregating exposures and derivatives instruments permitted to hedge a composite risk

In many cases, organizations hedged more than one risk simultaneously. For example, a cross currency interest rate swap hedged both the currency risk and floating interest rate risk of the underlying loan. Similarly, forecasted commodity imports lead to both commodity price risk and currency risk. Determining the quantum of exposure to hedge for one risk is in many cases dependent on the derivative instrument taken to hedge another risk.

AS-30 required that two separate hedging relationships be created for such exposures. Under IND-AS 109, an entity can treat both exposures along with one derivative as part of a single hedging relationship. The concept of aggregated exposure is depicted below:



Where the first level relationship is a cash flow hedge and the second level relationship is a fair value hedge or vice versa, even though the exposure is aggregated for the purpose of designation, the accounting implications for cash flow and fair value hedges will be followed separately for the different levels of the hedging relationship.

# Implementing hedge accounting under IND-AS 109

While ongoing maintenance of the hedge accounting framework is far less complex under IND-AS 109 compared to AS-30, clarity in hedging strategies and risk management objectives at the point of adoption is critical. It is also important to ensure that hedge documentation appropriately explains the economic relationship between the hedge item and hedging instruments as well as the off-set between the two. Given the move towards a more principle-based approach, ensuring that hedge documentation truly reflects the risk management objective is important both from an accounting and internal control stand-point.

'IND-AS 109 enables accounting for hedges in line with their actual risk management objective. Organizations should take this opportunity to re-align their hedging strategies with the genuine intent of protecting cash flows and determine the actual offset from hedging positions thereby aligning accounting with the real off-set.'

Organizations may adopt the following framework for adopting IND-AS 109:

	<p><b>Appropriate application of transition provisions and options</b></p> <ul style="list-style-type: none"> <li>Decision on whether to continue hedge accounting under AS-30</li> <li>Fair valuation of all derivatives including CVA/ DVA adjustments</li> <li>Determination of classification of financial assets and liabilities identified as hedged items</li> </ul>	<p><b>Identification of financial risks and alternative hedging strategies</b></p> <ul style="list-style-type: none"> <li>Study of underlying exposure profile and potential sources of financial risk</li> <li>Financial risk management strategy</li> <li>Identification of permissible hedging instruments</li> </ul>	<p><b>Evaluate economic relationship between each hedging instrument and underlying exposures</b></p> <ul style="list-style-type: none"> <li>Determination of genuine off-set between hedges and underlying exposures</li> <li>Documentation of hedging relationship</li> </ul>
Outputs to seek			
	<p><b>Enhance financial risk management policies to explain the economic relationship</b></p> <ul style="list-style-type: none"> <li>Financial risk management policies</li> <li>Hedge accounting policies and procedures</li> </ul>	<p><b>Development hedge documentation to explain the risk management objective and accounting treatment</b></p> <ul style="list-style-type: none"> <li>IND-AS 109 compliant hedge documentation</li> <li>Accounting entries under various scenarios</li> </ul>	<p><b>Design hedge designation and effectiveness assessment framework</b></p> <ul style="list-style-type: none"> <li>Ongoing hedge-exposure designation</li> <li>Hedge effectiveness assessment framework</li> <li>Ongoing CVA/ DVA adjusted fair valuation for hedged item and hedging instrument</li> </ul>
Outputs to seek			

# Deloitte service offerings

Our Global Treasury Advisory Services specializes in assisting organizations with their hedge accounting needs. We offer end-to-end services covering transition to hedge accounting, design of hedging strategies, development of financial risk management policies, fair valuation, accounting support and automation of the hedge accounting framework. Our service offerings are highlighted below:

Hedge accounting transition support	<ul style="list-style-type: none"><li>• Impact assessment of transition to hedge accounting under IND-AS 109</li><li>• Assistance in evaluation of options for adoption of hedge accounting principles</li></ul>
Fair valuation and hedge effectiveness assessment	<ul style="list-style-type: none"><li>• Fair valuation of hedged item and hedging instrument</li><li>• Credit value adjustment and debit value adjustment assessment</li><li>• Ongoing hedge effectiveness and offset assessment</li></ul>
Design of financial risk management strategy and policies	<ul style="list-style-type: none"><li>• Development of hedging strategies and overall financial risk management strategies</li><li>• Assistance in identification and pricing of hedging instruments</li></ul>
Development of hedge documentation framework	<ul style="list-style-type: none"><li>• Development of IND-AS 109 compliant hedge documentation framework</li><li>• Assistance with accounting entries and accounting implications under different scenarios</li></ul>
Managed services	<ul style="list-style-type: none"><li>• Fair valuation assistance at each reporting date</li><li>• Maintenance of hedge documentation on an ongoing basis</li><li>• On-call advisory support</li></ul>
Hedge accounting automation	<ul style="list-style-type: none"><li>• Bespoke development of hedge accounting and fair valuation tools</li><li>• Implementation of hedge accounting and fair valuation in existing treasury systems</li></ul>





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